



The
Economist

Out of puff

A survey of China | June 15th 2002

A dragon out of puff

Also in this section

Colour me grey

China's leadership is becoming ever more oligarchic—and ever less charismatic. Page 5

Seeds of change?

Deep in the countryside, China is experimenting with local democracy. Page 7

Money worries

The banking system is in a mess. How can it be sorted out? Page 8

No rural idyll

China's country dwellers find it hard to scrape a living. Page 10

Drastic medicine

Can capitalism provide a cure? Page 12

Urban discontent

City dwellers demand jobs and benefits. Page 13

Be prepared

For all that China is building up its external defences, its biggest battle will be at home. Page 15



With WTO membership under its belt, and a new leadership ready to take over later this year, China would seem well placed to tackle vital reforms. But expect a long wait, says James Miles

IF THE ebb and flow of China's recent history is any guide, the country is due for a period of momentous change. Every decade or so since the communists came to power in 1949 has seen a juddering shift of gear—the famine-inducing Great Leap Forward, the violent factional strife of the Cultural Revolution, the start of economic reforms and the nationwide anti-government demonstrations of 1989. And already two signposts to the next milestone have come into view.

The first was the country's accession to the World Trade Organisation (WTO) last December, after a 15-year quest. In theory this should not only provide the world with unprecedented access to China's markets, it should also bind China's economic reforms with the norms of international business. Optimists say it could eventually make China's secretive, undemocratic and corrupt government more open and accountable. Pessimists fear it could exacerbate unemployment and financial instability and hasten the collapse of the Communist Party.

The second is a quinquennial party congress due late in 2002 (with no date set yet) which will launch a series of leadership changes. These could be the most wide-ranging of the past two decades and open the way to a transfer of power to a younger, perhaps politically more open-minded, generation. It is equally possible, though, that the new leadership might try to shore up its legitimacy by beating the drum of nationalism and thereby push

China into confrontation with Taiwan, the United States and Japan. Rarely in recent years have there been such divergent views on where the country is heading.

That China has entered a critical phase of its economic reforms is not in doubt. But the hopes (or fears) raised by WTO accession and the prospect of a new generation of leaders are probably misplaced. The way China is run is unlikely to change as a consequence, at least not for several years. What will change China in the nearer term is the handling of the final and most arduous phase of its reform. The chances of failure are likely to rise as Chinese leaders become absorbed in the fractious politics of succession. And the consequence of failure could be the very upheaval that Chinese leaders have struggled so hard to avoid since the convulsion of 1989.

The terms of China's accession to the WTO are more far-reaching than those set for any other new member of the trading organisation or its predecessor, the General Agreement on Tariffs and Trade. They require China to open hitherto jealously guarded markets, such as banking, insurance, telecommunication and agriculture. In some sectors, the lowering of trade barriers will cause unemployment to rise. In others it will create new job opportunities. But tariff barriers are the least of China's problems: its own are already among the lowest of any developing country. Much more important, the country still needs to introduce many changes before it can call itself a market economy. With or ➤

Sources and acknowledgments

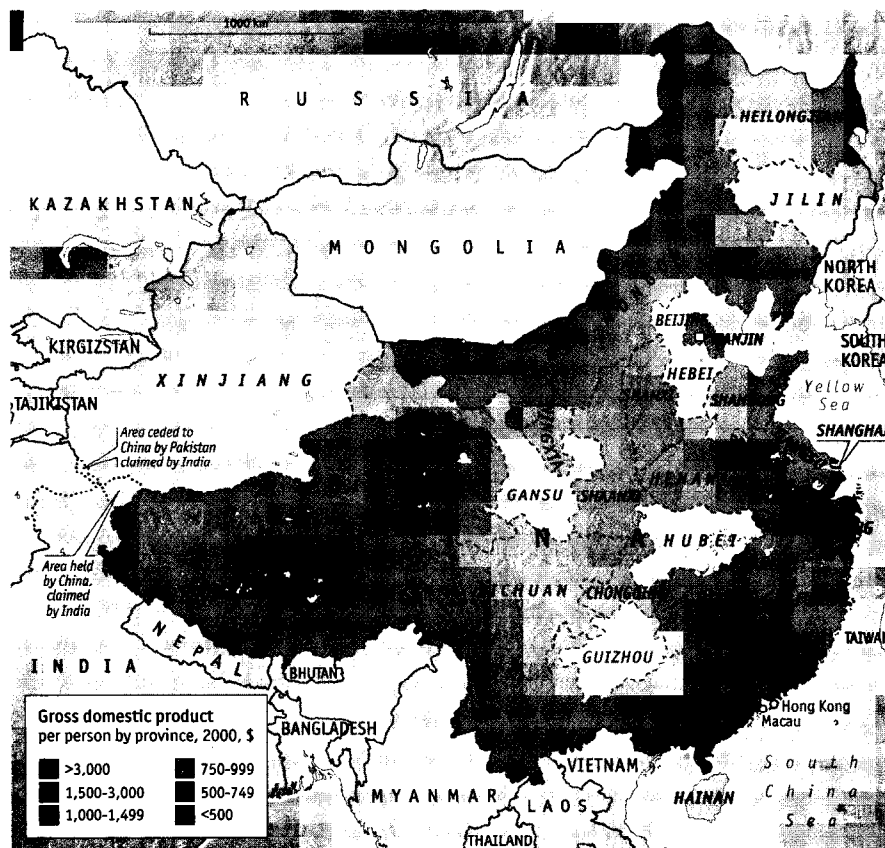
The author would like to thank Michelle Chan for her help in preparing this survey.

The following written sources were especially valuable: "China in the World Economy: the Domestic Policy Challenges", OECD, Paris 2002; "Integrating China into the Global Economy", by Nicholas R. Lardy, Brookings Institution Press, Washington, DC, 2002; "The China Dream: The Elusive Quest for the Greatest Untapped Market on Earth", by Joe Studwell, Profile Books, London 2002.

without the WTO, China needs to make those changes to keep its half-reformed economy from collapsing. To do this successfully, China must maintain brisk economic growth. Even at the official rate of 7.3% (which was probably an exaggeration), growth last year was insufficient to absorb the fast-swelling ranks of the unemployed. In the coming decade, China needs to create 8m-9m new jobs a year, up from 5.5m-6.5m in the second half of the 1990s, according to conservative World Bank estimates. It could be more. Yet average annual growth is expected to stick at around 7%, about 1.5 percentage points less than the average for the late 1990s.

Where once China was able to boost the economy by releasing the pent-up power of sectors restrained by Maoist folly (first agriculture, then small private and mixed-ownership enterprises), it has now run out of easy sources of new growth potential. It must get the marketplace to deploy labour and capital much more efficiently. Both are still being stifled by government interference. China's state-owned banks, which dominate the banking system, are technically insolvent thanks to indiscriminate, politically inspired lending to loss-making state enterprises. Moribund though most of it is, the state sector is still vital to China's economic and social stability because it employs (or at any rate keeps on its books) 45% of the urban workforce and receives most of the state banks' loans.

The various mechanisms that keep a market economy running, from public listings to bankruptcies, are still fettered by politics. In a recent book on China's business environment, "The China Dream", Joe Studwell put China's bankruptcy rate in the 1990s at no more than 0.05% a year, one-twentieth the level in America. China's two stockmarkets, now a decade



old, remain the almost exclusive preserve of inefficient state-owned enterprises. Most of the shares are held by the state or its employees, so ordinary shareholders have no influence over the way the companies are run (usually badly). One of China's richest private businessmen who knows the markets well calls them "congenitally deformed children born after the rape of capitalism by socialism".

Sustained high growth will require strong demand, yet the incomes of most rural residents (who account for 65% of the population) have been stagnating for the past four years. The only long-term solution will be to move the huge amount of surplus labour in the countryside—at least 150m people—into other sectors. Yet rural credit co-operatives, the obvious source of funding for rural industries, are bankrupt, and cities cannot provide enough jobs even for their own people, let alone an influx of peasants. China will benefit from continuing large inflows of foreign investment and a better export performance as the global economy recovers. But given the country's size, the economy still relies primarily on domestic engines of growth, which are sputtering. Growth over the past five years has relied heavily on massive government spending. As a result, the government's debt is rising fast. Coupled with the banks' bad loans and the state's huge pension liabilities, this is a financial crisis in the making.

Western governments and business

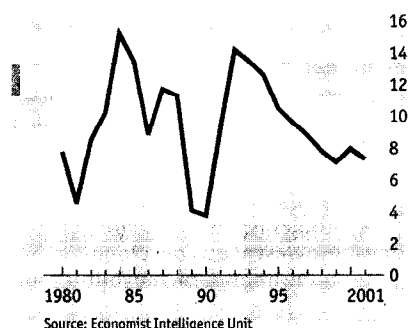
leaders once placed great hope in China's prime minister, Zhu Rongji, who took office in 1997 and successfully navigated the country through the financial crisis that erupted in the rest of Asia that year. But Mr Zhu is likely to step down when his current term of office ends in March 2003, with at best mixed results in reforming state enterprises and the banking system. Like the rest of China's leaders in recent times, he has been hamstrung by his unwillingness to do anything that might bring a repeat of the unrest of 1989. Will China's next crop of leaders be any more resolute?

New faces, old ideas

The forthcoming change in the party leadership is the first in communist China's history to be signalled in advance. Until now, changes at the top of the party have followed death or secretive party struggles. Even this time, there has been no public announcement that the current party chief, Jiang Zemin, will step down at the party's 16th congress later this year. Yet there have been many strong hints, some from Mr Jiang himself in meetings with foreign dignitaries, that after the congress he will be succeeded by the vice-president, Hu Jintao. The party's second-highest-ranking official, Li Peng—who played a prominent part in suppressing the 1989 protests—is also widely expected to leave the ruling Politburo, as is Mr Zhu, who ranks as number three. If all this comes to pass, it will be the first time since Mao's

Keep it up

China's real GDP, % increase on a year earlier



death that so many of the top jobs have changed hands at once.

Yet how much difference will these changes make to the way the country is run? Hopeful China-watchers point out that in Taiwan the Communist Party's erstwhile enemy, the Nationalist Party (Kuo-mintang), eventually embraced democracy after four decades of dictatorial rule during a period of rapid economic growth. But the Nationalist Party was not as weighed down by ideological baggage as the Communist Party. President Jiang's effort last year to open the party to the owners of private businesses (once decried as capitalist exploiters) was an attempt to lighten the load. Yet even that mild concession aroused furious debate within the party. Since then, party officials around the country have been told to exercise great caution when recruiting private businesspeople, and not to give them prominent positions in the party.

One thing the Communist Party does share with the Nationalist Party is a record of pervasive corruption. Economic growth helped the Nationalists survive, despite their poor image, until President Chen Shui-bian of the opposition Democratic Progressive Party defeated them in 2000. But to emulate that trick, China would need sustained double-digit growth to keep unemployment at bay. It has little chance of achieving that, nor would it want to, remembering the inflationary side-effects of its double-digit growth spurt in the early 1990s.

So the party's best bet for avoiding destabilising unrest would be to increase public participation in politics. However, many in the party fear that surrendering any power to the public might lead to a collapse reminiscent of the Soviet Union's. The younger generation of leaders show no signs of being any more courageous in this respect than their predecessors. Mr

Hu, at any rate, does not look like the bold, imaginative and determined leader that China needs to steer it through the next few critical years.

In the coming decade, therefore, China seems set to become more unstable. It will face growing unrest as unemployment mounts. And if growth were to slow significantly, public confidence could collapse, triggering a run on banks that would undermine China's financial stability.

As long as the leadership can avoid the kind of vicious internal struggles that prompted the 1989 unrest, the party will probably remain in power. But it will be a weakened, inward-looking organisation, vulnerable to crises. If this forecast proves correct, that is bad news for China and could be bad news for countries dealing with it. A weakly led and politically insecure China, roiled by unfulfilled nationalist aspirations, might prove an unpredictable actor on the world stage. ■

Colour me grey

CHINA is not a one-man dictatorship; it is a dictatorship of an ever-expanding circle within a self-selecting elite. One man makes the final decisions, but his options are constrained by the competing interests of his colleagues. Chairman Mao ruled as a dictator. Deng Xiaoping made more concessions to his rivals. Deng's successor, Jiang Zemin—lacking the charisma and authority to dictate—has moved even further towards rule by consensus. Mr Jiang's successor, soon to be formally anointed, will have neither revolutionary experience nor conspicuous contributions as an administrator to draw upon. He will be a grey apparatchik whose views as an individual will be less important than those of the collective around him.

Vice-President Hu Jintao, aged 59, is the man most likely to gain the formal trappings of power as Mr Jiang, 75, steps out of the limelight (though not necessarily out of the ruling circle). Mr Jiang has three titles that Mr Hu aspires to take over: general secretary of the Communist Party, state president, and chairman of the Central Military Commission (ie, commander-in-chief of the armed forces). The first title Mr Hu has a good chance of acquiring immediately after the party congress later this

year. The second he could add at the annual session of the legislature early next year. Whether Mr Jiang will hand over his third title is less certain, and if not, it will weaken Mr Hu. But as Mr Jiang knows, even having all three titles does not necessarily mean you are in charge.

Mr Jiang acquired the three top titles between 1989 and 1993, yet remained overshadowed by Deng, who exercised power informally well after he gave up his last position in 1990 (he died in 1997). When Deng relaunched China's economic reform efforts in 1992 and sent growth rates rocketing, his only title was that of honorary chairman of the Chinese Bridge Association. History could be about to repeat itself, with a semi-retired Mr Jiang making the key decisions behind the scenes. Only this time the relationship between elder statesman and formal incumbent could be a more uneasy one. Mr Hu is not Mr Jiang's choice for the job.

When he joined the Politburo's standing committee in 1992, Mr Hu was the youngest person to reach that position since the 1960s. But his meteoric rise to the top does not necessarily mark him out as a skilful political fighter. Chinese sources say he was put there at Deng's request to

China's leadership is becoming ever more oligarchic—and ever less charismatic



Jiang waves goodbye, maybe

be groomed as Mr Jiang's eventual successor. Mr Hu had distinguished himself not for his imaginative thinking, but for his loyalty. As the party chief of Tibet in the late 1980s, he had firmly suppressed anti-Chinese unrest there.

In Chinese political parlance, Mr Hu is likely to be dubbed the "core" of China's "fourth generation" of leaders, just as Mr Jiang has been the core of the third (Deng representing the second and Mao the first). But as leader-in-waiting for the past decade, Mr Hu has not made his mark on any aspect of Chinese policymaking. Perhaps he was trying to avoid the kind of atten- ►

tion that undid two of Deng's anointed successors, Hu Yaobang and Zhao Ziyang, both of whom were purged for expressing liberal ideas. Or perhaps, as one Chinese academic familiar with Hu Jintao's circle puts it, "he has no thoughts of own."

Optimists point to Mr Hu's record as president of the party school in Beijing, where senior cadres are trained for high office. Mr Hu took the post in 1993. Since then, the school has encouraged research into issues beyond the normal ideological staple of Marxism-Leninism-Mao Zedong Thought and Deng Xiaoping Theory, such as the development of social democratic parties in Europe.

No revolutionary

It is encouraging that such ideas are being discussed, but Mr Hu himself (maybe again to avoid undue attention) has stressed that he is not at all in favour of changing the way China is run. "Leading officials must at all times be on their guard against the plots of western hostile forces to 'split us up' or 'westernise' us, and against the danger of bringing about our own metamorphosis. There must be absolutely no hesitation or wavering in our commitment to Marxism and the pursuit of socialism with Chinese characteristics," he told party cadres in January 2000.

Still, the outside world will not have to worry too much about what Mr Hu is really thinking as long as Mr Jiang remains in the political game. He might do what Deng did in 1987 and keep his position as chairman of the Central Military Commission. Another idea he is rumoured to be keen on is creating a new body similar to America's National Security Council and making himself or a close ally chairman of it. Such a body would include representatives from the armed forces, the internal security apparatus, the foreign ministry and the party. China badly needs a better system of co-ordinating competing bureaucratic interests in the event of a foreign-policy crisis. When an American surveillance aircraft collided with a Chinese fighter plane off the Chinese coast last year, each of the seven members of the Politburo's standing committee had to tap into his own information networks before they were able to agree on their response, according to American sources.

It is a sad reflection on China's continuing dependence on personalities rather than institutions, but Mr Jiang may indeed be the best person to take charge of such a body. At least he has demonstrated an ability to keep the lid on hawkish anti-

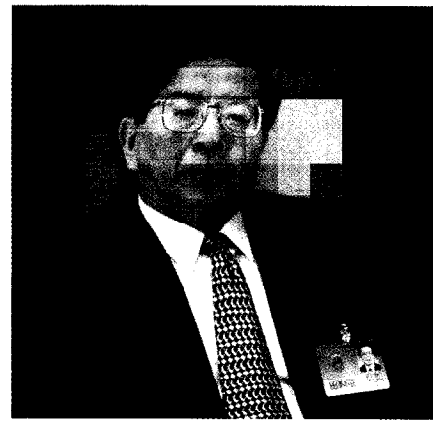
American sentiment within the armed forces and the party. Keeping a formal title would help him to maintain control.

Mr Hu has little experience in international affairs. He visited Western Europe for the first time last October and the United States for the first time only in May. How well he could handle a crisis as China's top leader is anyone's guess. His widely acclaimed photographic memory may make him a quick learner, but Mr Jiang has jealously guarded the foreign-policy portfolio. It is likely that Mr Hu will not only remain answerable to Mr Jiang, but will also be fenced in by Mr Jiang's appointees in the Central Military Commission and in the Politburo.

Chief among them is Zeng Qinghong, who is head of the party's organisation department (in charge of party recruitment and cadre appointments). Mr Zeng is a front-runner for promotion to the Politburo's standing committee as well as to a senior post in the Central Military Commission after this year's congress. He will be a powerful rival. For many years he has played a central behind-the-scenes role in foreign policy. When, after the crushing of the Tiananmen protests in 1989, top-level formal dialogue between the United States and China was severed, Mr Zeng was secretly appointed by the party to maintain informal contact with the then President Bush's National Security Council. If China creates its own security council, and if Mr Jiang decides not to lead it himself, Mr



Who's Hu?



Zeng the rocket scientist

Zeng would be a likely head. The close relationship between the two men annoys many in the party, which may explain Mr Jiang's repeated failure so far to get Mr Zeng promoted to full Politburo membership. A condition of Mr Jiang's retirement might be a bigger role for Mr Zeng.

But even though after the congress China will probably still be led by Jiang Zemin (even if not in name), a younger group of leaders will inevitably emerge in the coming decade as Mr Jiang and the two other powerful elders, Li Peng and Zhu Rongji (both 73), gradually fade out. By the time of the 17th party congress in 2007, the transfer of power will be complete. Yet the prospects for this "fourth generation" are not promising. Mr Hu—assuming he becomes the "core"—will face a dearth of educated talent among his generation. Some, like Mr Hu and Mr Zeng, managed to get a good education before the closure of most universities during the Cultural Revolution of 1966-76; Mr Hu is a power engineer and Mr Zeng a rocket scientist. But others further down the hierarchy were less fortunate.

Li Cheng of Hamilton College in upstate New York, who has written extensively on China's "fourth generation", argues that leaders in this category are likely to have been influenced by their experience of the ideologically inspired violence of the Cultural Revolution, making them more cynical about ideology, more open-minded and less confrontational than their predecessors in dealing with factional politics and social unrest. Yet the next generation of leaders also experienced the collapse of communism in Europe and the 1989 upheaval in China, which may have convinced many of them that any loosening of the party's grip on power could unleash violent upheaval. "Social democracy—without the democracy—is what they are interested in," says Jean-Pierre Cabestan of the French Centre for the Study of Contemporary China in Hong Kong. If so, sadly for China, that would make the fourth generation not very different from the third. ■

Seeds of change?

BUYUN TOWNSHIP is a cluster of villages set among steep hills, bamboo thickets and paddy fields in the heart of Sichuan Province. It is an hour and a half's drive along winding country roads to the nearest city. Many of Buyun's peasants have quit the land in search of jobs elsewhere. Those who remain eke out a living, mainly growing rice and wheat. It is in this dirt-poor backwater that some think they have spotted the seeds of a democratic transformation of China.

As the previous chapter argued, the new leadership that will begin to emerge in Beijing later this year may well be as suspicious of political reform as the current line-up. But democratic reforms such as those conducted in Buyun are starting to be introduced—albeit far from the centre of power—without the party's say-so, or at least with the encouragement only of certain groups within it. Optimists hope that as party control weakens at the grassroots, democratic institutions will begin to take their place and bring about change further up, whether the party likes it or not.

Both in China and abroad, in the past decade there has been much publicity about direct elections in most Chinese villages to the post of village chief. This innovation does not deserve as much fanfare as it has been getting. Village chiefs do have a say in how a village invests any collective funds, but they are not government officials, and are subordinate to village Communist Party secretaries. They are mainly factotums for the lowest tier of rural government, the township, which consists of a group of villages centred on a somewhat larger settlement.

All the same, many in the party are worried enough even about these village elections, let alone the idea of allowing people to elect a real government leader; and indeed in many places the village elections have led to fierce power struggles between the unelected party secretaries and the village chiefs returned in secret ballots. But in Buyun things have gone further. In 1998, without formal permission from the central leadership, the township conducted direct elections to the post of township chief, a person who holds government rank (but remains subordinate to the

party secretary at the corresponding level, as is every government leader in China).

Party leaders were anxious, but allowed Buyun to keep its newly elected chief, who happened in any case to be the party's nominee. Normally a township leader is indirectly elected by members of the township people's congress, and there is only one candidate: the party's choice. Members of the people's congress itself are carefully vetted by the party and elected by an unenthusiastic public. The congress acts as the local party's rubber stamp. Fearing that other townships would follow Buyun's example, a year ago the party issued "document number 12" which ordered that the usual indirect method of election be adhered to.

But there were loopholes in the document's wording that Buyun seized upon. Urged on by reformist officials and academics in Beijing as well as in the province itself, Buyun interpreted the party's orders creatively. Seeing that the orders allowed reforms in the way that candidates (but not the final winner) were selected, Buyun conducted competitive direct elections for a single candidate, who was then submitted to the township people's congress for approval. The result was the same as last time, albeit by a narrower margin: victory

for the party's favourite, Tan Xiaoqi.

According to Li Fan, a Beijing-based researcher who monitors rural politics, nearly one-third of Sichuan's 5,065 townships took advantage of the leeway offered by the document. They allowed the public to nominate candidates freely and then submitted the names to a vote by electoral colleges consisting of township officials, people's congress members and village representatives. This method still left plenty of scope for party interference, but it was a small step forward.

Buyun's reformist supporters hope that its elections will eventually transform Chinese politics. The example they point to is a decision in 1978 by peasants in Xiaogang village in eastern Anhui province to split up their communal land into household plots. It was a hugely risky move at the time, but the reform had powerful backers in Beijing and eventually spread across the country, transforming Chinese agriculture. Five years later the disastrous People's Communes that Mao had foisted on peasants were formally scrapped.

Already in some places, the introduction of direct elections for village chief is causing democracy to percolate into party organs too. New methods of choosing party secretaries are now being tried, with ►►



A fluid situation

the party's encouragement. "If there are no corresponding changes in the method of choosing [the party secretary], and if the level of democracy and openness is not expanded...[the party's secretary's] prestige and ability to mobilise will be undermined," said one party journal.

Small beginnings

But can such slow reforms really make a difference in the face of rapid economic and social change? Mr Li, the researcher, says that experiments in rural areas of Sichuan (and to a more limited extent elsewhere) are unlikely to transform China's politics. "The village is not so strong politically. It is isolated. If urban areas start to reform it will be much faster," he says.

Since 1999, the central government has approved cautious experiments with direct elections in a few urban areas, albeit only at the level of the neighbourhood committee. These committees, like their counterparts in the villages, are not a formal branch of government. Many urban residents hold them in disdain, not least because they are charged with enforcing the unpopular one-child-per-couple rule.

Mr Li admits that in most places where such elections have been tried, residents

have shown little enthusiasm. For one thing, many citizens still receive most of their benefits—including health care and education—from their government employers, so have little need for the services of the neighbourhood committees. But Mr Li believes that in the north-eastern city of Shenyang, where unemployment is high, elections have helped to prevent large-scale unrest: "Giving more power to the people is good. Democracy is the way."

Many of China's current leaders remain unconvinced that democracy helps to defuse social tensions, and given the way it is being introduced they may have a point. A one-party dictatorship cannot co-exist with a parallel democracy without arousing political conflict. This has already happened at the village level, and could happen at the township level too. It is only by good fortune that in Buyun the elected chief gets on well with the party secretary.

And even in Buyun, not everyone is happy with this kind of democracy. "Since this township chief took power, to tell you the truth life for ordinary people is still very miserable. Although he's improved some roads and hooked us up to cable tv, it's still tough for ordinary people," says a sceptical schoolteacher. "Fees imposed on

peasants are still too high," says another villager. Both asked to remain anonymous. The local authorities do not welcome visits from foreign journalists.

Mr Li predicts that China could have directly elected city mayors within ten years and a directly elected president within 20 years. For public consumption, party leaders themselves do not rule out the possibility that China might one day introduce such reforms. In the 1980s Deng Xiaoping suggested that China might have general elections within 50 years. But to achieve this, it would have to abandon the idea of a one-party dictatorship altogether. Unfortunately the party so abhors any organisation not under its control—whether political, religious or even charitable—that there is nothing to take its place. Dissidents who tried to organise a nationwide opposition party in 1998 were jailed, and no one has tried since, although the Chinese media occasionally air the idea of more thorough political reform.

The leadership is fearful of acting, and will probably remain so until some colossal social or political shock forces it to change. One potential candidate is a collapse of confidence in China's feeble banking system. ■

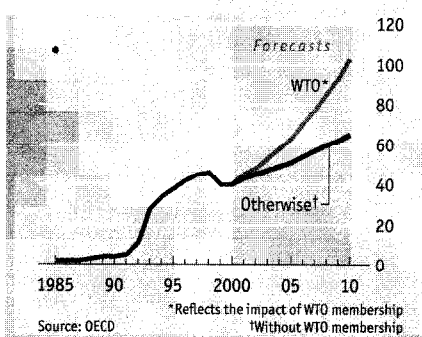
Money worries

THE most likely successor to China's prime minister, Zhu Rongji, is a thin, mild-mannered man who will face an even tougher task than his fiery-tempered predecessor. As the Communist Party's mouthpiece, the *People's Daily*, warned in February, "Often the biggest risk in the course of economic development is that of a financial crisis." It will require skilful leadership to prevent such a crisis in China in the coming years.

For the past four years, Wen Jiabao, a geologist by training, has had a tough apprenticeship as deputy prime minister with particular responsibility for financial and agricultural affairs. He has fought, with little success, to reduce the state-owned banks' non-performing loans. He has struggled, with equally meagre results, to reinvigorate the depressed rural economy. As an ordinary Politburo member, Mr Wen has had to defer to others, including Mr Zhu, in making policy decisions.

One bright spot

FDI inflows into China, \$bn



But assuming that Mr Wen is promoted to the Politburo's standing committee later this year, and to the post of prime minister early next year (as Mr Zhu hopes he will be), is he likely to tackle these problems any more successfully?

The banking system is in a mess. How can it be sorted out?

One of the gloomiest predictions comes from an American lawyer, Gordon Chang, who left China in 2001 after living and working in Shanghai for nearly two decades. In his book, "The Coming Collapse of China" (Random House, 2001), Mr Chang argued that China's entry to the WTO would "shake the government to its foundations". Of the banking system, he wrote: "It is here...that the end of the modern Chinese state might well begin." Mr Chang said China had about five years in which to sort out its financial mess, including a fast-growing budget deficit, or else face "the laws of gravity".

Mr Chang is probably overdoing the gloom. WTO entry itself will not precipitate a regime-threatening crisis in China. But the country's financial problems are indeed colossal, and could cause serious economic and social disruption unless tackled effectively.

China enjoys some protection because ►►

its currency is not fully convertible, making it difficult for ordinary Chinese citizens to move their money elsewhere and impossible for foreigners to move money into or out of China's stockmarkets (except for special shares priced in foreign currency). The country also has a trade surplus, low short-term foreign debt and large inflows of foreign direct investment. In a recent study, the OECD predicted that China's entry to the WTO could cause the country's current-account surplus to turn to deficit by the middle of this decade. But it said this would not pose a serious risk to China's (huge) foreign-exchange reserves.

Vicious circle

All the same, the OECD study argues that a "severe vicious circle" has developed in China. The banks cannot restore their solvency unless enterprise performance improves substantially, but the high level of non-performing loans makes it difficult for banks to provide the funds that enterprises need to restructure and improve their performance. This weakens efforts to improve the banks' credit culture and blunts incentives for enterprises to improve their governance. Poor governance, in turn, blocks the development of capital markets as alternative financial outlets.

The picture is as grim as it was in many South-East Asian countries after the Asian financial crisis in 1997. Officially, non-performing loans (NPLs) in China's state-owned banks amount to 25% of total outstanding loans. But this figure uses an old method of calculating NPLs, and Chinese officials say that if new criteria were used the figure would probably be around 30%. According to Nicholas Lardy of the Brookings Institution, an American think-tank, figures published in 1999 using both the old and the new criteria suggest that the real figure might be more like 50%.

Whether it is 30% or 50%, it points to a dangerously weak banking system—and this is after the transfer of about \$170 billion of NPLs (about 18% of total loans) to asset-management companies in 2000. China has been putting pressure on banks to reduce the NPL ratio to 15% (judged by the new criteria) by 2005. This has increased the incentive for officials to distort the figures.

The problem is even more worrying when seen as part of the government's overall debt. Here again the official figure is misleading. The government says its debt-to-GDP ratio is a very manageable 16%. In fact if hidden liabilities, including NPLs, pension commitments and bonds issued



Better not bank on it

to capitalise the asset-management companies are taken into account, the debt-to-GDP ratio is more like 100%. "If you continue the current performance...the system is going to crash in seven to eight years. You are heading towards [a situation like] Russia in 1998 with a default on the domestic bond market," says Mr Lardy.

It is argued that China's accession to the WTO will help make Chinese industry more competitive to allow it to meet the growing challenge of foreign rivals. But this cannot happen if the banking system does not work. "If transformation (of the banks) is delayed and banks continue to channel disproportionate amounts of funds to inefficient state-owned companies, the leverage of WTO commitments on domestic economic reform will be largely lost," Mr Lardy wrote in a recent book on China's WTO accession, "Integrating China into the Global Economy".

On the face of it, China has a strong incentive to move quickly. Two years after WTO entry, foreign banks will be allowed to do business with companies in the Chinese currency, the renminbi. Five years after entry, they will be allowed to do ren-

minbi business with individual Chinese. In the most apocalyptic scenario, these changes could prompt a rush by individual savers and companies to withdraw deposits from state-owned banks and put them into more reliable foreign ones. The result would be a banking crisis. But in practice this is highly unlikely to happen.

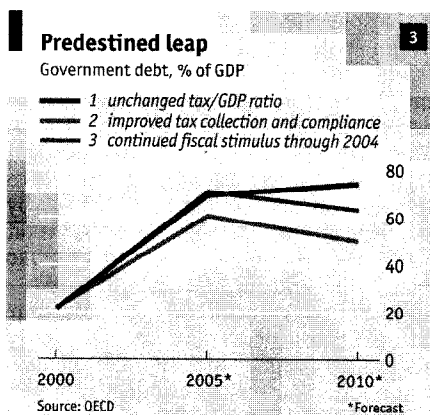
Chinese-currency holders will be deterred from transferring their accounts to foreign banks because these will have far fewer branches than Chinese banks. China requires foreign banks to provide operating capital of at least 600m yuan (\$73m) for each branch that does business in renminbi. That will be a high price to pay, high enough to discourage foreign banks from attempting to compete for the custom of small depositors.

Too big to fail

All in all, the expansion of foreign banks after WTO entry poses less of a risk to China's banking system than the existing problems of financial weakness, poor credit control and bad governance among borrowers. Maintaining public confidence in the banking system is crucial. More than half the total liquidity is provided by hundreds of millions of individual savers. Last year those individual deposits grew twice as fast as the official GDP figure, despite interest-rate cuts. The public rightly believes that in the event of a crisis the state would bail out the banks.

"The risks of a near-term banking crisis are limited," says a senior official in an international financial institution. "The question is how long this state guarantee will remain credible. Will it be undermined by the overall level of fiscal debt?" In Beijing, a prominent economist, Fan Gang, is confident there will be no run on banks. As long as the growth of new NPLs is kept under control, their ratio to GDP will fall as output expands. The official forecast for annual GDP growth is over 7% for at least the next five years. "China cannot afford to have a growth rate of 3% or 2%. You have to keep things going. That's the fate of a developing country. If you stop, you're dead," says Mr Fan.

So can the balance sheets of China's banks be cleaned up? The country's experience so far with asset management companies (AMCs) does not inspire confidence. The AMCs buy the NPLs at face value from the banks and swap them for equity shares in the enterprises concerned. They also sell off the loans for whatever they can get for them—on average around 20% of their face value. But this ►►



ratio will plunge in future because the best assets in the AMCs' portfolios have been sold first. The AMCs are having to borrow money to pay interest on the bonds they issued to the banks in return for the NPLs. When the bonds mature, the government will have to bail out the AMCs.

There is little evidence that the AMCs have helped to improve the governance of enterprises in which they have acquired a stake. Nor have they encouraged the banks

to become any more responsible in their lending. The banks know that if their NPLs build up again, the government will probably transfer them to the AMCs.

The OECD study calculates that the cost of reducing the NPL ratio to 10% in the big four commercial banks and other financial institutions, and of recapitalising the banks, could be 30-60% of GDP. That is high but not impossible. A rapid and decisive effort, says the OECD, would be less

costly than letting the problems persist.

But such a move would require a revolutionary change in the way China's banks and enterprises operate, otherwise the problems will soon reappear. If he becomes prime minister, the consensus-seeking Mr Wen will need to get very tough indeed. And to ensure the growth he needs to carry out reforms, the first thing he will have to do is improve the lot of China's discontented farmers. ■

No rural idyll

WANG HONGBIN, the Communist Party chief of Nanjie village in the northern province of Henan, says he has few worries about China's entry to the WTO. His village is in the heart of the country's central plains, amid an endless expanse of wheat fields dotted with tiny villages. Farmers around here should be nervous about WTO entry: the price of their grain is 15-20% higher than in world markets. As China lowers its barriers to grain and other agricultural imports, wheat prices here are likely to drop. Most Chinese farmers have already endured four years of stagnating incomes. In the next few years, nearly 60% of peasants in Henan expect their incomes to fall or at best remain the same, according to a recent survey conducted by Chinese researchers.

But Mr Wang's village is better prepared than many. Most of the 70m farmers in this province work on plots of land too small to benefit from mechanisation, but Nanjie has transformed itself from an impoverished rural backwater into an impressive-looking spread of factories and apartment blocks. Agriculture has been consigned to the sidelines as Nanjie has used village labour to make instant noodles, beer, packaging materials and a variety of other products.

The village owes its achievements to the collectivisation of its land, which has allowed it to redeploy surplus labour in industry. One of the biggest problems China will have to face in the coming years is finding jobs for at least 150m rural residents for whom there is little to do on the plots of land allocated to them (in Henan, under an acre per household). The OECD estimates that between 1997 and 2010, agricultural employment will fall by around

China's country dwellers find it hard to scrape a living



Nanjie put Mao on a pedestal

78m (only 3m more than if China had not joined the WTO). Reallocating this labour and using the land more profitably is essential to maintaining economic growth and social stability in the countryside.

Despite Nanjie's success, its approach is a non-starter for most peasants because land is the only form of social security they have. They have to pay for education and health care, and they get no pensions. They would agree to collectivising only if they could be confident they could earn money and provide for their old age by other means. Few are. Nanjie pulled it off partly because it is next to a county seat, so many villagers could work in the town.

The other reason is Nanjie's leadership. Many Chinese peasants despise the party secretaries assigned to every village, but in Nanjie Mr Wang is the subject of a personality cult rivalling that of Chairman

Mao. Indeed, Mr Wang has adopted Maoism as the village ideology. A decade ago, he erected a 10-metre statue of the late chairman in the centre of the village, guarded round the clock by two militia guards armed with pistols. Schoolchildren in Nanjie learn Chairman Mao's essays by heart, and every household has a Mao statuette on display in the living room.

Chinese leaders recognise that farmers have had a rough time. In 1999, income from planting crops averaged \$108 per farmer; in 2000, it dropped to \$96, recovering only slightly to \$99 last year. Average prices for agricultural produce in China are 20-40% higher than world prices, and supply far outstrips domestic demand, so prices are likely to fall. Boosting rural incomes—whether by moving farmers into industry or into more profitable agricultural production—is vital to ensure sus- ➤

► tained economic growth.

Two decades ago, China decided to break up the Maoist "people's communes" and divide farmland into household plots. At the time it was a splendid idea, at last giving peasants an incentive to work. Both output and incomes soared. But now the countryside is left with a colossal burden: far too many people cultivating far too little land which they can neither sell nor mortgage. With two-thirds of China's population living in the countryside, including towns in rural areas, stagnating rural incomes make it harder for a consumer market to develop. Average rural incomes are only one-third those in urban areas.

Nanjie abandoned the household farming system five years after it was introduced in the village in 1981. Many of Nanjie's peasants had already left their land to work in the town. Mr Wang began by taking over two village factories (which he claimed had violated their contracts) and putting them under collective control. Two years later he called on villagers to surrender their individual land-use claims to the collective. In return they would get jobs in the factories and a monthly handout of flour. Since the land produced so little income, they duly obliged.

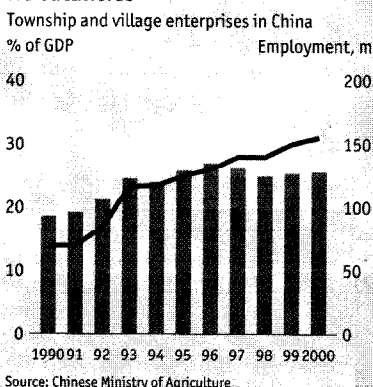
A model of its kind

Today Nanjie, with its 3,000 permanent residents and 10,000 contract workers, boasts an output value (unaudited) of around \$160m. Visitors to Nanjie have only to look at some of the neighbouring villages, where there is little industry, houses are dilapidated and land is farmed in an inefficient patchwork of household plots, to realise that this is quite an achievement. But even Nanjie is now in trouble.

The problem is one that besets many of China's rural industries. Along the eastern seaboard, these developed rapidly from the mid-1980s to the mid-1990s (far less so in inland areas such as Henan). During this period, township and village enterprises were the biggest contributors to growth in employment and GDP and played a crucial role in boosting rural incomes. By the end of 1996, they employed 135m people, contributing nearly half of China's exports, compared with one-sixth at the beginning of the decade. But since then they have gone into decline.

Last year, rural enterprises increased their value-added by 8%, but their number fell by 620,000 and employment was down 5m on the 1996 peak. And opportunities for peasants are becoming harder to find: half of those who get new jobs in ru-

No vacancies



ral enterprises are workers laid off from urban areas.

Why this decline in what was once the most promising sector of the Chinese economy? One reason is the sharp devaluation of other Asian currencies during the region's financial crisis of 1997, which has made the enterprises' exports less competitive. Another is the credit crunch brought about by China's efforts to reduce non-performing loans in the banking system. In 1997, township and village enterprises accounted for 6.7% of bank loans, already absurdly low given their importance to the economy. By 2001, their share had declined to 5.7%.

A more fundamental problem has been the way these enterprises are run. Many were, in effect, under the control of township and village governments (euphemistically described as "collective ownership"), resulting in poor management and irrational investment decisions. Many of these have now been privatised, but the private sector in China is especially

starved of capital.

Nanjie's problems are potentially greater than most. It truly is a collective, with the village providing free housing, schooling, health care and food for all its permanent residents. Yet in the past five years, output value has declined by 19%, and the future looks bleak. Income from tourists keen to study its social and economic model or savour its Maoist revivalism is probably a main lifeline. According to one of Mr Wang's aides, some 300,000 people visit every year.

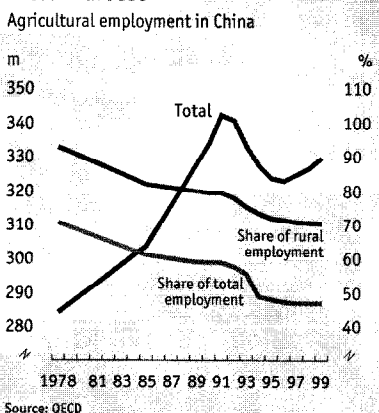
Noodles, noodles everywhere

Increasingly fierce competition has hit Nanjie hard. Taiwanese noodle manufacturers have rapidly expanded their market share in China, and small-scale beer production has proliferated across Henan. As a diversified conglomerate, Nanjie has been able to cross-subsidise the losses suffered by its beer and noodle factories from more profitable enterprises such as colour printing, condiments and packing materials. And thanks to generous support from higher-level government, Nanjie has been able to increase its borrowing from \$60m three years ago to over \$97m now. But fierce price competition has sucked Nanjie into a dispute with rival beer producers that has undermined its squeaky-clean, model-village image.

Nanjie's proximity to a town and to a major highway through the province will help it survive. But many small and isolated rural enterprises will be unable to compete as larger-scale private businesses develop in urban areas. WTO entry will help boost some exports that could absorb rural labour, including fruit and vegetables, clothing and textiles. But these new opportunities will be relatively small, and they could disappear again if China's key export markets, such as America and Japan, impose safeguards to protect their own industries from Chinese exports.

Even in the highly unlikely event that China's debt-plagued banks were to extend more credit to rural businesses, this would solve only part of the problem. Despite privatisation, government interference remains a heavy burden. Reforms to the tax system in 1994 gave the central government a bigger share of tax revenue and left many township and village governments close to bankruptcy. Many rural governments now depend on indiscriminate, often illegal, levies on businesses and households to pay the salaries of officials and sustain basic services such as education and health care.

Bitter harvest



► Taxes on enterprises are low in China compared with many other developing countries. But in the countryside, ad-hoc fees often consume 20% of post-tax profits, far more than the taxes themselves. Such fees are also heaped upon individual farmers, who end up paying a higher proportion of their incomes in fees and taxes than do urban residents. Government efforts to stop this practice have met with limited success. The plan is to replace all fees with a uniform tax, but this has encountered strong resistance among rural governments, which are worried about losing even more of their revenue.

The result is growing rural discontent, with ever more frequent outbreaks of un-

rest. "More and more peasants are submitting petitions concerning the excessive burden [of fees and taxes], and conflicts [between officials and peasants] are becoming increasingly intense," said an unusually frank report on causes of social instability in China published by the Communist Party last year. Rural unrest worries the government, but not as much as urban unrest because it is easier to suppress without drawing unwanted attention. Although party rhetoric stresses the importance of rural stability, urban centres will continue to attract a bigger share of the central government's resources.

Ultimately, China's surplus rural workers will need to move into urban areas. But

the government, fearful of creating its own versions of Mumbai with endless shantytown sprawls, is hesitant to open the doors to peasant migration. Where restrictions have recently been lifted, it has been mainly in smaller cities. Many peasants work in large cities illegally, but they are denied education for their children, health care and pension benefits. They cannot buy housing, and remain dependant on village land for security in their old age. The system does not prevent the migration needed to ensure a continuing supply of cheap labour, but it is very unfair. No wonder that nearly 80% of peasants in the Henan survey said they were dissatisfied. But would they be any happier in the cities? ■

Drastic medicine

Can capitalism provide a cure?

IN THE coastal province of Jiangsu, one county has been trying out a daring way of coping with the debt that has crippled rural governments and devastated health care and education across much of the Chinese countryside: it has privatised hospitals and schools. Shuyang county is tearing down the last crumbling walls of rural China's socialist edifice.

Fang Wen and Zhou Youming are now the proud owners of the Maowei Township Hospital, one of 38 such facilities that were quietly auctioned off by the county

authorities in 2000. The selling spree left only the two biggest hospitals still in government hands. "There was no way out but to reform," says Mr Zhou. The hospitals could not pay their staff. Many had no x-ray machines, heart monitors or ultrasound equipment. According to a report in the Chinese press, one Shuyang hospital had an operating table with only three legs. A patient rolled off it during an appendectomy.

Mr Fang and Mr Zhou bought their hospital for \$51,000, \$14,000 more than the reserve price. "Ordinary people had objections to the auctions. They felt there was nothing in it for them," Mr Zhou admits. There did not seem to be much in it for the new owners either, except a dilapidated facility with no equipment, no beds and 30 staff to pay.

Before the hospital changed hands, residents of Maowei Township preferred to go to neighbouring townships for treatment because their own facility was so poor. Fewer patients meant less revenue for the hospital, which meant less money to spend on equipment, and hence even fewer patients. For a year before it was sold, the hospital could not afford to pay its staff any wages. Employees supported themselves as best they could, using the wards as pigsties and chicken coops.

Mr Zhou and Mr Fang spent another \$70,000 buying new equipment, including beds and x-ray and ultrasound ma-

chines, helped by earnings from Mr Zhou's sideline business growing flowers and trees. Things are now looking up. The hospital gets 50 patients a day, more than five times as many as before. Salaries have increased by 20-30%. So what does this mean for the hospital's economics? "I am not pursuing profits," insists Mr Zhou. A visitor to his hospital says the charges are about the same as before. Mr Zhou says they are lower.

Shuyang county may be embracing capitalism, but it still feels uncomfortable with its language. Privatisation is referred to as "changing the system", "turning into an industry" or, more forthrightly, "cutting off the milk supply". Across this county of 1.7m people, the experiment has met with mixed success. According to Mr Zhou, eight hospitals have improved since privatisation, ten are about the same and conditions at the other 20 have deteriorated.

The privatisation of schools has also run into difficulties. Here too the county had acted out of desperation: the pay for Shuyang's 11,000 teachers was equivalent to 70% of the county's revenue. In the late 1990s, Shuyang and other counties within Suqian municipality began selling off, merging and closing down schools. But according to residents, Shuyang halted sales in 2000 as parents began to complain about the high fees charged by the private schools.



Try going private



Urban discontent

City dwellers demand jobs and benefits

IN A cramped café with half a dozen tables and a bare concrete floor, the manageress laments the slide of the one-time industrial powerhouse of Fushun, in Liaoning province, into economic ruin. "Almost everyone has lost their jobs," she says. "The young people you see hanging around are all former workers in the factories. People come here in the evening to drink because they are so depressed." She herself was laid off from the city's state-owned aluminium factory two years ago.

Liquor, at least, is cheap: a 450 ml bottle of Fushun's brand of fiery sorghum spirit costs 35 cents. Her impoverished customers prefer it by the glassful—12 cents buys enough to dull the senses to the grimness of the place. But there is not enough business to bring the manageress or her husband any profit. As laid-off workers, they should be allowed to run their business tax-free. But the government taxes them anyway, and the state-run school that their 10-year-old son attends illegally demands fees. "I'll be begging in the streets in five years," says the woman. "I'll probably have committed suicide by then," says an assistant, with not a hint of irony.

Fushun is a city of 1.4m people in the heart of China's rustbelt in the north-east. Its main industries are large and state-owned: coal mining, oil refining, steel and aluminium. The city seems a world away from the dynamic coastal boom towns. People sit with handwritten placards round their necks offering their services as labourers or craftsmen. Every few days a group of workers or pensioners stage a demonstration, bringing traffic to a halt. Their grievances are usually unpaid wages or pensions, or meagre severance pay.

In March, protests erupted simultaneously in Fushun and two other north-eastern cities, Liaoyang and Daqing. Fushun's involved only a few hundred peo-

ple, but the other two drew tens of thousands and went on for several days. In Liaoyang, smaller protests periodically erupted well into May. It was one of the biggest outbreaks of labour unrest reported in China in well over a decade. The government quelled it in the usual manner, rounding up the ringleaders and promising the others more money. This has been standard procedure since a bout of rioting in the Liaoning town of Yangjiazhangzi two years ago, which prompted a review of the rules to ensure that any unrest was quickly dealt with.

Large-scale urban unrest could draw in discontented people from many different backgrounds and undermine the normal functioning of government and vital parts of the economy. It could also, as happened in 1989, exacerbate divisions in the party. Hu Xingdou, an economist at the Beijing Institute of Technology, argues that, unlike Russia, China has tackled the easier parts of its reform process first, leaving the problems with the biggest potential for disruption to accumulate. "China has not yet crossed the most difficult hurdles...so I say the real unrest is yet to happen. What happened in 1989 was just a preliminary stage," says Mr Hu, whose doom-laden essay, "China: the Danger of Turmoil" (the official code for the events of 1989), has been widely posted on Chinese websites.

Trouble ahead

In its annual report on social trends, the Chinese Academy of Social Sciences said that in the coming years China's unemployment rate could surge above 15% (compared with an official figure of 3.6% in urban areas now, though unofficial estimates put it at 8-20%). "If this is not dealt with effectively, it could lead to social turmoil," the study cautioned. The inflow of foreign investment prompted by China's

entry into the WTO would further widen the gap between rich and poor, thus "causing urban residents to become even more unsettled."

China will almost certainly face growing urban unrest in the years ahead, but not every part of the country will be equally affected. Big cities in the east with fast-growing economies will suffer less than the more backward inland areas and those with concentrations of large state-owned industries. Beijing and Shanghai, the two most important cities, are likely to remain in the former category.

Fushun, on the other hand, is a powder keg. Unemployment there is the worst of any big city in Liaoning province. In the province as a whole, redundant workers (who remain technically employed but receive no salary) at the end of 2000 made up 29% of the total workforce in the state sector. In Fushun, where the state sector accounts for three-quarters of the workforce, the figure was 43%. This amounts to massive hidden unemployment: the city's official unemployment rate was a disingenuous 2.7%. Redundant workers receive an average subsistence payment of just over \$100 per year, less than half the national average. They have little to lose by taking to the streets.

The latest bout of unrest in Fushun and other north-eastern cities was sparked by official attempts to pay off redundant workers and leave them to fend for themselves. In Fushun, coal miners complained that their severance packages amounted to a paltry \$85 for each year of service. Such protests will almost certainly get worse. Between 1998 and 2000 Fushun formally laid off some 50,000 employees of state-owned enterprises, but six times as many remained to be dealt with.

China is trying to set up a social-security system to take over the welfare role ►►

once played by the enterprises. Local governments are supposed to guarantee that no benefits will be lost in the transition to the new system (under which both employers and workers make contributions, some of which go into portable individual pension accounts), but in practice many do not have enough money.

Employees of state-owned enterprises moving into the private sector are particularly anxious, given that many private enterprises have yet to set up pension arrangements of any kind. "For private enterprises, joining the system means adding a new and heavy tax. Naturally they will try to evade the tax by refusing to join, and if...forced to join will report smaller wage bills or fewer workers, or simply go underground," wrote two Chinese scholars in a paper published last year.

Replacing the iron rice bowl

The anxiety of state-enterprise workers will increase as China tries to grapple with pension liabilities that are growing far faster than contributions. The World Bank estimates that the number of people aged 65 and over in China will rise from 76m in 1995 to 300m by 2050. The ratio of workers to pensioners is expected to decline to 3 to 1 in 2050 from 10 to 1 in 1995, thanks to the urban one-child-per-couple policy that has caused the birth rate to drop.

Most of the money paid into the individual pension accounts does not go into independently managed investment funds, but is used to meet existing commitments. The government sets the rates of return, which are lower than those on government bonds. This pay-as-you-go system has been in deficit since the late 1990s. A pension crisis is in the making.

At present the government bails out the system with contributions from the central budget. McKinsey, a consultancy firm, estimates that the government must fill a pension gap of \$15 billion by 2005 and \$110 billion by 2010. The country needs to move rapidly away from pay-as-you-go towards fully funded individual accounts. Yet even if the government could find the money to pay for the unfunded pensions, perhaps through bond issues, setting up a funded system would require it to tackle a range of other equally intractable issues.

Pension funds need efficient capital markets in which to invest. China's stunted bond markets and casino-like stockmarkets will not do. "It's going to take a generation of accounting and auditing and legal specialists to create the transparency [in the Chinese bond market] that

we need," says Gary Benanav, chief executive of New York Life, an insurance company. The company is one of many international insurers eager to tap into China's market, which is opening up far wider to foreigners as a result of WTO entry.

To help fund social-security commitments, China has tried to sell off its shareholdings in listed companies. But it is afraid to sell government shares for fear of angering the millions of ordinary shareholders whose investments might be wiped out by a flood of new stock. Wrathful members of the new middle class could cause more mischief than angry workers in the rustbelt of the north-east.

In the relatively prosperous east the problems are less acute. Job opportunities are far more plentiful and social security is better funded. The city of Beijing has faced only occasional small protests over labour issues—nothing like 1989 when hundreds of thousands of students, factory workers and others converged on Tiananmen Square. But the party fears that as the state retreats from the economy, its own ability to keep control will diminish correspondingly. Hu Jintao has attributed the spread of the Falun Gong sect to the "lack of cohesion and fighting power among some party organisations", as well as the party's failure to establish a strong presence in "newly established businesses", for which read the most dynamic area of the economy: the private sector.

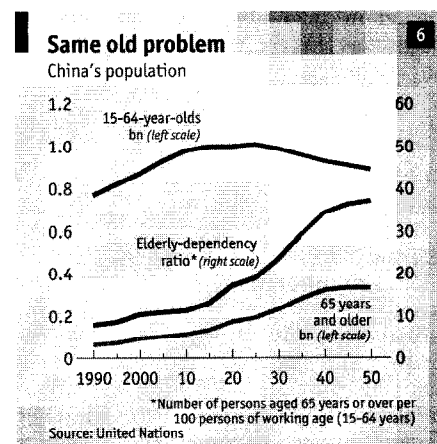
In Shenyang, some 32,000 party members left their state-enterprise jobs between 1990 and 1999. About half of them moved into the private sector, but very few have been able to join party cells at their new employers. Indeed, only about 5% of non-state enterprises in the city have such cells. In another decade or two, urban party branches may find themselves

largely confined to the government sector. In Shenyang, only 29 new party members were recruited from non-state enterprises in 1999, a sector that employed nearly 640,000 people in the city in that year.

Although the immediate trigger for urban protests is usually some economic grievance, demonstrators often also complain about official corruption, which thrives in China's partially reformed, barely regulated environment. There is increasing public resentment of party officials and factory managers siphoning off state assets, including pension and unemployment-insurance funds, to do their own business, or simply to live it up. Billions of dollars are secreted abroad every year. Indeed, corruption is far worse now than it was in 1989, when it was one of the main causes of the anti-government protests. In Fushun, modern-looking government and party buildings preside over streets of closed factory gates and decaying apartment blocks. In nearby Shenyang, the capital of Liaoning province, a huge scandal erupted last year, linking many of the city's top officials with a local mafia gang. The deputy mayor was executed and the mayor sentenced to life in prison.

Urban stability is also threatened by the fast-growing gap between rich and poor. As one academic put it recently in an official Chinese journal: "No regime can maintain political stability when there is serious economic inequality." What has exacerbated the problem in China is the unusual speed at which the income gap between rich and poor has grown in urban areas over the past decade. "If we cannot effectively manage social tensions [arising from inequality], then it is possible that economic crisis will beget social crisis and social crisis will beget political crisis," writes Hu Angang, a well-known economist, in a recent article, citing Indonesia and the collapse of President Suharto's regime in 1998 as an example of what could go wrong. Hu Xingdou, the economist, says that if urban growth rates were to slow down, "the result would be too dreadful to contemplate."

After reaching a peak of 113m in 1995, the number of people employed by urban state-owned enterprises has fallen by nearly a third. Despite this downsizing, protests such as those in the north-east this year remain the exception, and have not (yet) escalated into a serious political crisis. But as many as half of those remaining at their posts remain surplus to requirements, and may yet lose their jobs. There could be a lot more trouble to come. ■



Be prepared

THERE is a curious contradiction between China's vigorous embrace of information technology on the one hand and the myopic nationalism of many of those who use it on the other. If public sentiment had to be judged by the outpourings on the country's numerous Internet bulletin boards, it would appear alarmingly chauvinistic and bellicose. In reality, nationalist sentiment in China is not demonstrably stronger now than it has been for decades. What has changed is the ability of ordinary Chinese to express it. The media are far more responsive to the demands of the marketplace than they were a decade ago, even if they remain far from objective. The Internet has provided an outlet for a small, predominantly urban, well-educated, young and male sector of society to air its views.

Many outside China worry about this overt nationalism, fearing that the country might turn into a Germany or Japan before the second world war: suspicious of the outside world, gaining in economic strength and determined to exercise its growing power. That fear is misplaced. The bigger risk is of a weak and divided China forced by public opinion to deviate from the pragmatic line towards the West and Taiwan that has guided Chinese foreign policy in the past two decades.

The eruption of anti-western protests in 1999 after the bombing of the Chinese embassy in Belgrade showed that even under President Jiang Zemin, who has been especially eager to forge closer ties with the Americans, the government felt that it had to allow public anger to express itself. With a new, inexperienced leadership after the party congress in the autumn, there is a danger of more to come.

Attacking the Americans and Japanese is safe for China's people because the party does so itself (though despite the nationalist noises, the urban elite aspires to the trappings of western consumer culture). The party maintains these attacks because its legitimacy partly rests on its nationalist credentials for having allowed China to stand up for itself after a century of encroachment by colonial powers. Yet in the years ahead, Chinese leaders are likely to be wary of trying to exploit

nationalist sentiment because they know it could backfire on them.

In the coming years, America and its friends will have to deal with a China preoccupied with navigating the country through a period of heightened instability. This China will not be eager to exploit volatile nationalist passions that could undermine economic development and exacerbate political divisions. It will be nervous and introspective.

President Clinton, whose rhetoric towards China flip-flopped from hostility to appeasement during his eight years in office, sought a more balanced approach in a speech he delivered in April 1999 in which he urged that: "As we focus on the potential challenge that a strong China could present to the United States in the future, let us not forget the risk of a weak China, beset by internal conflict, social dislocation and criminal activity, becoming a vast zone of instability in Asia."

A weak China, however, will still be busy acquiring new weaponry and deploying it for potential use in the Taiwan Strait. This year it has placed orders for two more Sovremenny-class destroyers from Russia, having taken delivery of its first two in 2000. American officials believe these ships are intended to deter intervention by American aircraft carriers in any conflict over Taiwan. Other additions to the Chinese armoury (also bought from Russia) in recent years are four Kilo-class diesel submarines and at least 90 SU-27 and SU-30 fighter aircraft. China has also continued its build-up of short-range ballistic missiles (M-9 and M-11) on the coast facing Taiwan. American officials expect some 600 Chinese missiles to be in place by the middle of the decade.

China is also modernising its strategic nuclear missiles, about 20 of which are capable of reaching the United States. The aim is to make them less vulnerable to a pre-emptive strike by the Americans. China is developing solid-fuelled missiles that can be moved by road, which could be launched much faster. The Russians are helping China to build a nuclear-fuelled ballistic-missile submarine that could be in service by the end of the decade.

These capabilities are worrying to the

For all that China is building up its external defences, its biggest battle will be at home

Americans, but none of them makes China a strategic threat in the same way that the Soviet Union once was. China's nuclear arsenal is dwarfed by America's, even after reductions just agreed between American and Russia that would leave them with between 1,700 and 2,200 warheads each. America's hoped-for missile-defence system would undermine the deterrent value of a strengthened Chinese nuclear arsenal. A senior American official talks about China's "five-minute navy", which could be destroyed by American missiles. The Kilo-class submarines as well as new diesel submarines built by China itself suffer from operational problems.

The Taiwan card

President Bush's emphasis on the relationship with Taiwan has riled China. Soon after taking office he offered to sell the island diesel submarines, submarine-hunting surveillance aircraft, destroyers and advanced air-to-air missiles. He also promised to "help Taiwan defend itself" in the event of a Chinese assault. The terrorist attacks against America on September 11th (cheered by Chinese nationalists on the Internet) seem to have done little to change underlying mutual suspicions, despite Chinese hopes that they would bind the two countries closer together in a common cause against Islamic extremism. But China's focus on internal stability and its preoccupation with the politics of succession have enabled Sino-American relations to remain on an even keel.

For all the friction between America and China over issues ranging from human rights to weapons proliferation, the likelihood of armed conflict remains slim. Taiwan's independence-leaning leadership will continue to anger China by trying to raise its international profile. But it will stop well short of any constitutional change that would formally sever the notional links between the island and the mainland.

America's defence establishment will continue to hedge against the possibility of Chinese aggression by boosting its military presence in Asia, but its political leadership will try to engage China on as many fronts as possible. Mr Bush, helped by ad- ➤

vice from his father, favours this approach, in spite of reservations on the part of some of his close political allies, particularly in the Pentagon. It will be a relationship subject to frequent crises, but most unlikely to fall apart entirely. Economic interdependence between the two countries will increase as China implements its market-opening commitments under WTO rules.

And for all its rhetorical bluster over Taiwan, and despite the arms build-up, China knows that any military strike against the island would need to secure an outright victory (of which there could be no guarantee) or risk inflicting huge political damage on the leadership. The success last year of Beijing's bid to stage the Olympic Games in 2008 is also likely to act as a restraint. China will not want to spoil the coming-out party for its "fourth-generation" leaders.

Chinese nationalism, though contained for now by the country's leadership, will always worry China's neighbours, particularly Japan and Taiwan. Whatever happens, China's secretive military modernisation will encourage defensive efforts by others in the region. "China is changing very rapidly. Its emergence [as a military and economic power] will have an effect on Japanese security policy, India's and maybe ultimately Russia's," says a Pentagon official.

A hegemon, but not yet

Some Chinese officials, including senior members of the armed forces and the party, openly suggest that they want to see China as the pre-eminent power in Asia, with America and Japan consigned to the sidelines. But there is little evidence of a concerted policy to that end. And even if there were, achieving such a goal would involve either open conflict—which China will do its best to avoid because of worries about its own weakness—or, more likely, a very long wait until the country's economic and military strength make it the de facto hegemon. By then the Communist Party may look very different—less driven by historical animosities and far more influenced by younger, western-educated people who have returned to China.

As China turns itself into the biggest manufacturing base in the global economic chain, it will need to rely increasingly on imported oil. By 2020, it could be importing as much as 60% of its needs, having been largely self-sufficient until 1993-96. This may bring its perception of global security issues closer to those of America, Japan and other big oil importers, and may



Something to look forward to

make it act more like a country that depends on the West and its markets.

But for all the optimism generated abroad by China's accession to the WTO, foreigners will continue to encounter many obstacles in trying to do business there. The central government may have good intentions, but a myriad local governments will fight tooth and nail to protect their vested interests. And should growth slow down significantly, WTO membership is sure to be blamed. Foreign investors, who so far have encountered surprisingly little nationalistic opposition in China, may then find the going tougher.

The next few years in China will certainly be more turbulent. Economic disparities between regions and between town and country will grow wider, and the urban areas themselves will become more polarised. The booming cities of skyscrapers and glittering shopping malls that so impress foreign visitors to China will, over time, start to look more like cities in other developing countries as country

dwellers move in. The shanty towns will spread. And as the market economy develops and the state sector decays, people will feel freer and bolder, while the party will become ever more corrupt.

As long as there is relative unity among the country's top leaders, China will be able to withstand a greater degree of social and economic instability and maintain a generally pragmatic foreign-policy line. The unrest in 1989 got out of hand only because of a leadership struggle that had become highly visible in the months before the protests. The ideological schisms which caused that struggle have largely healed. There is now a broad consensus on the need for a market economy (if not on how exactly to get there). But Chinese leaders are also united in their belief that tolerating organised political opposition might result in their downfall, and should therefore be avoided at all costs. Those who expect the staging of the Olympics in Beijing to encourage greater political tolerance are likely to be disappointed. ■

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